

Petition of Bay State Gas Company, pursuant to G.L.
c.164, § 94 and 220 C.M.R. § 6.00 *et. seq.*,
for authority to establish Gas Cost Incentive Mechanism

D.T.E. 01-81

July 16, 2002

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**COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

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**INITIAL BRIEF
OF THE ATTORNEY GENERAL**

I. INTRODUCTION

Pursuant to the briefing schedule established by the Department of Telecommunications and Energy (“Department”) in this proceeding, the Attorney General submits his Initial Brief to address the petition (“Petition”) filed by Bay State Gas Company (“Bay State” or the “Company”) in which the Company seeks the Department’s authorization to establish a Gas Cost Incentive Mechanism (“GCIM”). The Department should reject the Company’s Petition and its GCIM proposal. Bay State has not shown that its proposal would lower, rather than raise, gas costs and help, rather than harm, its ratepayers. To the contrary, the GCIM proposal will increase direct transaction costs, the cost of gas purchased, and capital costs, while stifling nascent competition in the gas supply market.

A. Procedural Background

On October 26, 2001, Bay State filed a Petition with the Department seeking authority to implement the proposed GCIM. Exh. BSG-1. On December 4, 2002, the Department issued an Order of Notice commencing an investigation into the Company’s Petition and scheduling a

public hearing and procedural conference on the matter.¹ On January 3, 2002, the Department held a public hearing and procedural conference and established a procedural schedule governing the time frame for discovery and evidentiary hearings. On May 6, 2002, the Department commenced evidentiary hearings but suspended these hearings when it learned that the Company sought to make material changes to its Petition and/or proposed GCIM (*i.e.*, offer an alternative to the originally proposed sharing mechanism), but had not given notice of the changes to the parties.² Tr. 1, pp.10-11, 51-54. The Department continued the evidentiary hearings on June 19 and 20, 2002.

B. Statement Of The Case

The Company proposes to create a new incentive mechanism component of the Cost of Gas Adjustment Clause (“CGAC”) which the Company contends will reduce the overall commodity cost of gas for its customers. *See* Exh. AG-1, p. 4; Exh. BSG-1, pp. 3-5; Exh. BSG-3, pp. 2-4; Exh. BSG-4, p. 1. The Company’s GCIM proposal would allow the Company to enter into various financial and physical hedging markets in order to outperform the indexes of certain gas supply contracts. *See* Exh. AG-1, p. 4; Exh. BSG-3, pp. 17-19. The Company also proposes to expand the types of costs that are recoverable through the CGAC in order to recover the costs of the GCIM program. *See* Exh. AG-1, p. 4; Exh. BSG-1, p. 4. The Company proposes that

¹ That same day, the Department commenced a generic investigation into the appropriateness of the use of risk management techniques to mitigate natural gas price volatility. *Risk Management NOI*, D.T.E. 01-100 (2001). The Attorney General filed Comments on January 14, 2002.

² The Department directed the Company to file supplemental testimony and/or tariffs reflecting the changes and to revise all answers to discovery based on those changes. The Department also granted intervenors an opportunity to conduct additional discovery relating to the changes as well as an opportunity to file supplemental testimony.

customers receive 25% of any net trading gains realized,³ but that the Company absorb 100% of any net trading losses incurred.⁴ See Exh. AG-2, p.2; Exh. BSG-4, p. 3. The Company proposes to determine net trading gains and losses semi-annually to coincide with the cost of gas adjustment (“CGA”) periods. See BSG-4, p. 4. Finally, the Company proposes to implement the GCIM for an initial period of three years.⁵

II. STANDARD OF REVIEW

The standard of review for any incentive proposal is subject to the standard of review of G.L. c. 164, § 94, which requires that rates be just and reasonable. *Incentive Regulation for Gas and Electric Companies*, D.P.U. 94-158, p. 52 (1995). As in a rate case under G.L. c. 164, § 94, the burden of demonstrating that a particular incentive proposal is consistent with that standard is on the proponent. *Id.* at 52. Additionally, the proponent must show that the incentive proposal is consistent with the Department’s goal of providing a framework that ensures that the utility provides safe, reliable and least-cost service. *Id.*

III. ARGUMENT

A. The Company Has failed To Demonstrate That The GCIM Proposal Would Yield Least-Cost Service Or Benefit Its Ratepayers.

The first problem with the Company’s GCIM proposal is that it would cause customers to

³ The Company proposes that customers bear all of the other incremental costs associated with administering, supporting and financing its proposal, which could cost millions of dollars. See Exh. AG-2, p. 3.

⁴ In its original GCIM proposal, the Company had proposed that customers share in both the net trading gains and losses associated with the proposal. See Exh. AG-1, p. 4; Exh. BSG-3, p. 28.

⁵ The Company reserves the right to file for consideration of a change in the sharing mechanism during the initial three-year period.

face incremental costs. Although the Company modified its GCIM proposal on the first day of hearings to eliminate customers' sharing in trading losses, that modification does not shield customers from bearing the burden of incremental costs associated with the GCIM proposal. The incremental costs include: (1) new transaction costs, (2) additional personnel, (3) new computer hardware and software, (4) new accounting and auditing costs, (5) added insurance costs, (6) additional regulatory costs and other "associated transaction costs", and (7) ultimately increased cost of capital.⁶ *See e.g.*, Exh. AG-1, pp. 8-9; Exh. AG-2, pp. 2-3; Exh. AG-1-30; Exh. AG-2-3; Exh. DTE-1-19; Exh. DTE-1-34.

The Company contends that the GCIM proposal will likely result in lower overall gas costs for its customers and just and reasonable rates that "reflect the company's maximization of opportunities to achieve the lowest possible costs for its customers." *See* Exh. BSG-3, p. 2-3, 17; Exh. BSG-4, p. 1; Exh. BSG-3, p.15; Tr.2, p. 76-77. The Company claims that under the proposed GCIM, "its customers will either accrue benefits or be no worse off than they would have been without a GCIM." Exh. BSG-4, p. 3. The Company's contentions lack merit and are not supported by the record evidence.

The Company has not proved that the GCIM proposal would actually lower rather than raise gas costs.⁷ Bay State has presented no evidence that 25% of unknown and speculative gas cost savings under the GCIM would outweigh the program's incremental costs. The Company

⁶ Bay State has one of the lowest rated bonds of any regulated utility in Massachusetts. *See* Exh. AG-2, p.4. Indeed, the Company is on the brink of being non-investment grade. *See* Exh. AG-2, p.4. Debt costs aside, the GCIM proposal adds additional risk to the Company and as such affects the Company's financial integrity and ultimately its cost of equity.

⁷ The Company has not even demonstrated that its customers will break even as compared to the current system.

was unable to guarantee that there would even be any benefits from its proposed trading activities. Tr. 2 at 81; *see also* Exh. BSG-4, p. 3. Bay State clearly hopes and expects that it will be able to realize net gains under the GCIM proposal, but hopes and expectations are not evidence. Company witness Stephen Bryant was unable to point to any proof that customers would pay less for gas, noting only “there is a reasonable expectation that customers will experience lower gas costs.” Tr. 2 at 70. The Company provided no support for that expectation or any basis why such an expectation is “reasonable” under these circumstances. Customers may or may not receive benefits from gains from Bay State’s transactions, but they definitely will pay the incremental costs of implementing the program.

The Company’s revised GCIM proposal should not be found to provide least cost service, benefit ratepayers, or yield just and reasonable rates where the evidence shows that Bay State’s customers are certain to pay additional costs for gas supply under the GCIM proposal than under the current system, and may or may not experience any savings. The Company’s GCIM proposal fails to meet the Department’s standards that rates under an incentive proposal must be just and reasonable and provide a framework that ensures safe, reliable, least-cost service. *See Incentive Regulation for Gas and Electric Companies*, D.P.U. 94-158, p. 52 (1995).

B. The GCIM Proposal Would Stifle Competition In The Competitive Gas Supply Market.

The Department has made substantial efforts to open the utilities’ natural gas supply business to competition. The initiatives include: 1) unbundling of rates; 2) providing for third party gas supply management, billing and metering; 3) reducing gas supply contract lives; 4) initiating competitive supplier pilot projects; and 5) educating customers about the market for

competitive supplies. While the competitive gas supply market has reached some of the largest customers, it has not reached most smaller users, either residential or commercial customers.

The Department would stifle competition in the nascent gas supply market if it allows new products for the monopoly local distribution company that the competitive market can and should provide. The Department should allow the competitive market to provide gas services with fixed prices, capped prices or any of the plethora of pricing variations, created with or without hedging techniques. The competitive market is the appropriate vehicle for these products, since its players will have the expertise to market and price these products and the financial expertise, breadth and depth to analyze and trade any underlying derivative products. Ultimately, the players in the marketplace, who are much better suited to evaluate and manage those risks than are utilities, should bear the significant risks associated with any hedging.

The Company's proposed GCIM is just the kind of monopoly service that would stifle gas supply competition. *See* Exh. AG-1, p.3. The proposed GCIM would place competitive suppliers at a disadvantage because any company that offers gas priced on a managed-risk basis as a competitive alternative would incur customer acquisition costs as part of its gas-merchant function. *See* Tr. 2, pp. 151-155, 161-163; Tr. 3, pp. 332, 339-341; Exh. AE-1. Bay State, with its established customer base would incur none of these customer acquisition costs under its GCIM proposal. *See* Tr. 2, p. 154. The Company's GCIM proposal would allow the Company to earn incentives from the gas that it sells to its current customers, hindering the competitive suppliers' ability to compete.⁸ *See* Tr. 2, pp. 151-155, 161-163; Tr. 3, pp. 332, 339-341; Exh.

⁸ The Company claims that it enjoys no advantage over alternative suppliers because there really are no alternative or competitive suppliers for the vast majority of the customers that it serves. *See* Tr. 2, pp. 158-160. This claim ignores the potential harm to both the current competition for industrial and large

AE-1. The Company's GCIM proposal also creates strong incentives for the Company to hinder any attempt by its customers to leave the GCAC service.

The Company's GCIM proposal therefore fails to meet the Department's requirement that an incentive proposal be consistent with market-based regulation and enhanced competition as well as complement the ongoing movement towards a more market-based utility framework. *See Incentive Regulation for Gas and Electric Companies*, D.P.U. 94-158, p. 58 (1995).

IV. CONCLUSION

For these reasons, the Attorney General requests that the Department issue an Order rejecting the Company's Petition and its GCIM proposal.

RESPECTFULLY SUBMITTED,

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commercial customer gas supply and future competition for smaller customer gas supply. *Id.* at 158-159; *see also* Tr. 3, pp. 339-341.